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How Courts Can Prevent Excess Emitters From Using Bankruptcy as a Forum to Avoid California AB 32's Allowance Deductions

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HOW COURTS CAN PREVENT EXCESS EMITTERS FROM USING BANKRUPTCY AS A FORUM TO AVOID CALIFORNIA AB 32'S ALLOWANCE DEDUCTIONS

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California's AB 32 institutes a comprehensive cap-and-trade program designed to reduce California's greenhouse gas production to 1990 levels by 2020. But bankruptcy laws may allow entities to avoid AB 32's allowance deductions. Broad interpretations of Section 363(f)'s "interests in such property" allow the possibility of environmental obligations being sold free and clear of their interests on the violating company's assets. Moreover, the company may be able to form a new identity that purchases these assets to continue operations, only without the burdensome, delayed penalties of AB 32. Courts, however, have the power to deny AB 32's circumvention by refusing to extend case law that liberally interprets "interest in such property."

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I. INTRODUCTION

AB 32 institutes a comprehensive cap-and-trade program designed to reduce California's greenhouse gas production levels.[1] Greenhouse gas production will initially be capped at the emissions expected to be produced in 2012 from covered sources.[2] Entities covered by AB 32 are to be allotted allowances equal to their market share of this total cap.[3] Each allowance represents one $MTCO_2E$.[4] Allowances will gradually decline until emissions reach 1990 levels by 2020.[5]

AB 32 seeks to ensure compliance by penalizing violators in two ways. First, excess emitters will forfeit four allowances per excess $MTCO_2E$ production.[6] Second, late fines are assessed until the entity either turns in the correct number of allowances or they will be forced to forfeit future allowances.[7]

This paper identifies bankruptcy as a forum in which entities that exceed their emissions limit might be able to avoid the accompanying allowance deduction. Specifically, an entity might be able to sell its assets free and clear of its allowance deduction liabilities through Section 363 to a new company comprised of the same actors. Part II contrasts which liabilities can be discharged through a Chapter 11 plan and which can be avoided through a free and clear sale under Section 363. Part III analyzes whether allowance deductions could be discharged through a Chapter 11 plan or avoided through a free and clear sale under Section 363. Part IV discusses measures which would strengthen AB 32 against such possible abuse. Part V concludes.

II. THE DEBTOR'S ENVIRONMENTAL OBLIGATIONS IN CHAPTER 11 COMPARED TO A SECTION 363 SALE

A. Application in a Chapter 11 Plan

Chapter 11 provides that, with some exceptions, the confirmation of a plan "discharges the debtor from any debt that arose before the date of such confirmation."[8] "Debt" means liability on a "claim."[9] Whether an

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[1] CAL. CODE REGS. tit. 17, § 95801 (2014).
[2] CAL. CODE REGS. tit. 17, § 95812 (2014).
[3] *Id.*
[4] *Id.*
[5] CAL. HEALTH & SAFETY CODE § 38550 (2014).
[6] CAL. CODE REGS. tit. 17, § 96014(a).
[7] CAL. CODE REGS. tit. 17, § 96014(b).
[8] 11 U.S.C. § 1141(d)(1)(A).

environmental obligation imposed on the debtor will follow the debtor after a plan thus depends on whether the obligation falls within the Bankruptcy Code's definition of a claim.

The Bankruptcy Code's broad definition of the word "claim" is emblematic of the Code's policy to allow the debtor to start anew. [10]A claim is either a:

> "(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
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> (B) right to an equitable remedy for breach of performance if such breach gives right to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured."[11]

The only real derived limits to a claim from this intentionally broad definition is that the claimant must be seeking a (1) pre-confirmation (2) right to payment.[12]

1. Courts Are Split on How to Calculate When an Environmental Liability Arises

The filing of a bankruptcy petition creates an estate distinct from the debtor.[13] The bankruptcy estate is comprised of all of the debtor's property, legal and equitable interests, and, importantly, all liabilities on claims.[14] Confirmation of a chapter 11 plan discharges all pre-confirmation claims.[15] Thus, any liability which arises post-confirmation thus would not be a claim and the reorganized debtor will be liable on them in full.

Environmental liabilities do not fit neatly within Section 101(5)'s definition of claim, particularly when the conduct leading to environmental liability arises pre-confirmation but the right to payment becomes clear post-

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[9] 11 U.S.C. § 101(12).

[10] "By this broadest possible definition . . . the bill contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case."In re *Chateaugay Corp*., 944 F.2d 997, 1003 (2d Cir. 1991) (quoting H.R.Rep. No. 95-595, at 309 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6266).

[11] 11 U.S.C. § 101(5).

[12] Hon. Stephen Raslavich et al., *Charting a Course Through an Unsettled Environment: a Look at the Law of Successor Liability for Environmental Claims*, 14 J. BANKR. L. & PRAC. 3 Art. 1.

[13] 11 U.S.C. § 541.

[14] *Id*.

[15] 11 U.S.C. § 1141(d)(1).

confirmation. Courts have struggled with when such environmental liabilities should be deemed to have arisen, particularly when the claim arises pre-petition and is treated as a general unsecured claim.[16] Three main approaches have developed to evaluate these situations: (1) the relationship test; (2) the conduct test; and (3) simply looking towards nonbankruptcy law.

a. Second Circuit's Relationship Test

The Second Circuit ruled in *In re Chateaugay, Corp.,*[17] that whether an injured party has a dischargeable claim for pre-petition[18] conduct depends on the parties' pre-existing relationship. The debtor, LTV, was identified by the EPA as a "potentially responsible party" jointly liable under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA")[19] for industrial hazardous substance generation.[20] The EPA filed a timely proof of claim, asserting that it incurred $32 million in pre-petition response costs.[21] The EPA additionally filed claims for further anticipated cleanup costs.[22] The EPA brought an action for a declaratory judgment demanding that their post-confirmation cleanup costs be non-dischargeable.[23]

The EPA argued that, like some tort claims, where injury from pre-petition conduct manifests post-confirmation, environmental hazards whose post-confirmation injury arises from pre-petition conduct should similarly not be recognized as a claim dischargeable in bankruptcy.[24]

The court rejected the EPA's argument, holding instead that the EPA's claim was not outside of the definition of "claim," but rather qualified as a "contingent" claim.[25] The court reasoned that, unlike tort claimants, there is a pre-existing relationship between the EPA and industrial waste generators in which provides "'sufficient contemplation' of contingencies to bring most

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[16] Debts that arise between the filing of the plan and confirmation vary in treatment depending on their characteristics. 11 U.S.C. § 507. The most common form of compensation is in the form of an administrative expense. *Id.* An administrative expense gets paid after secured claims but before nearly all unsecured claims. *Id.*

[17] 944 F.2d 997, 999 (2d Cir. 1991).

[18] While the confirmation of a chapter 11 plan discharges all pre-confirmation claims as opposed to pre-petition claims, environmental obligations are at the highest risk of being avoided if they arose pre-petition. *See* 11 U.S.C. § 507, *supra* note 19.

[19] 42 U.S.C. §§ 9601–9672.

[20] In re *Chateaugay Corp*., 944 F.2d at 999.

[21] *Id.*

[22] *Id*. at 1001.

[23] *Id*. at 1000.

[24] *Id*. at 1004.

[25] *Id.*

ultimately maturing payment obligations based on pre-petition conduct within the definition of 'claims.'"[26] As such, the court looked to when the EPA's contingent claim arose, namely, when the debtor's conduct created the ultimate obligation.[27] This was, of course, pre-confirmation, and thus a dischargeable claim.[28]

The impact of the court's reasoning renders nearly all claims from an environmental agency against a violating debtor to fall under the definition of "claim." The environmental agency will nearly always meet the requisite "contemplation" of the contingency that the debtor's actions could ultimately lead to environmental liability.

b. Ninth Circuit's Conduct Test

The Ninth Circuit held in *In re Jensen*[29] that the debtor's conduct determines when liability arises. The case involved an individual Chapter 7[30] debtor who, several weeks after filing for bankruptcy protection, was discovered during an inspection by the California Water Board to be spilling fungicide into a body of water.[31] The California Water Board proceeded to clean up the site and subsequently sought indemnification from the debtor.[32] The debtor moved for summary judgment on the grounds that the indemnification sought was a claim.[33] The California Water Board, probably realizing that they would be paid very little (if anything) in a liquidation proceeding, argued that the cleanup costs were not a pre-petition debt capable of being discharged.[34]

The court reasoned that Congress wanted as broad a definition of the word "claim" as possible, and so the appropriate rule for determining when a claim arose was based on the debtor's first act that led to the ultimate liability.[35] The debt was therefore discharged in bankruptcy.[36]

Similar to the Second Circuit, the Ninth Circuit favors debtors. By using

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[26] *Id*. at 1005.

[27] *Id.* at 1004.

[28] *Id.* at 1000.

[29] In re *Jensen*, 995 F.2d 925, 931 (9th Cir. 1993).

[30] The case was converted from Chapter 11 to Chapter 7. *Id*. at 926.

[31] *Id.*

[32] *Id.* at 926–28.

[33] *Id.* at 927.

[34] *Id.*

[35] *Id.* at 930. Due process requirements of notice exist for bankruptcy claims. The court therefore also needed to find that the California Water Board had sufficient knowledge of the claim before it could find the debt discharged. *Id*. at 931.

[36] *Id*.

the debtor's conduct as the measuring point, the court is in effect looking as far back on the continuum as possible, thereby increasing the chance that the claim will be pre-petition and therefore allowed.[37] The only real distinction between the Second and Ninth Circuit tests is that the Second Circuit crafted its test such that it extinguishes the possibility that tort claims can be discharged based on the timing of the debtor's conduct.[38] The tests impact environmental claims identically.

c. District Court of Minnesota's Test: Nonbankruptcy Law Controls

The District Court of Minnesota's ruling in *Union Scrap Iron & Metal*[39] is, in contrast to the Second and Ninth Circuits, very favorable to environmental agencies. The EPA brought an action against the defendant, Union Scrap Iron & Metal, in 1990 seeking indemnification under CERCLA for cleanup costs allegedly related to the defendant's automobile battery processing activity from 1979 to 1982.[40] The defendant had filed a chapter 11 bankruptcy petition in 1982 and the plan of reorganization was confirmed in 1985.[41] The defendant brought a motion to dismiss, arguing that the plan's confirmation discharged the EPA's debt.[42]

The court held that nonbankruptcy law—in this case CERCLA—determines the relationship between a debtor and a third party.[43] The court noted that one of the elements of CERCLA liability is the incurrence by the United States of necessary costs in responding to the hazard.[44] The court reasoned that the claim could not be considered pre-confirmation because the EPA had not incurred any costs until after confirmation.[45] The claim could thus not be discharged.[46]

The court's decision favors environmental agencies by postponing the timing of the claim's incurrence until the last possible moment—until all of the nonbankruptcy law elements of a legal obligation are met. The decision stands

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[37] Absent a successful objection. 11 U.S.C. § 502(a) (2012).

[38] *See In re Chateaugay Corp*., 944 F.2d at 1004.

[39] *United States v. Union Scrap Iron & Metal*, 123 B.R. 831 (D. Minn. 1990).

[40] *Id.* at 834.

[41] *Id.* at 833. .

[42] *Id.* at 833–34. The confirmation of a chapter 11 plan discharges all pre-confirmation claims. 11 U.S.C. § 1141(d)(1).

[43] *Union Scrap Iron & Metal*, 123 B.R. at 835.

[44] *Id*.

[45] *Id.* at 836-37.

[46] *Id.*

in stark contrast to the Second and Ninth Circuit tests, which favor the debtor.[47]

2. Right to Payment

A claim in a chapter 11 case will only be discharged if it is both pre-confirmation and can be reduced to payment.[48] Environmental claims, however, often include or consist entirely of an imposed obligation. Courts weigh two factors to determine whether such an obligation creates "a right to payment."[49] First, the debtor must be able to comply with the injunction.[50] Second, the environmental harm must not be ongoing.[51]

a. Debtor's Ability to Comply With the Regulation

In the case of an equitable remedy, the question becomes whether the environmental agency may receive damages to ameliorate the harm as an alternative to the debtor performing his or her obligations. The obligation can be reduced to payment if the aggrieved party can receive damages to ameliorate the harm.[52]

Courts have consistently held that an obligation can be reduced to payment if the state has the ability to be reimbursed by the debtor.[53] The state's incurrence of monetary costs thus resembles a typical creditor-debtor relationship: the state essentially loans money to the debtor and later seeks payment on the loan.

Going a step further, the state's claim may be deemed to have been reduced to an obligation for payment where the debtor has been divested of the ability to perform the obligation. The state in *Kovacs* had received a judicial

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[47] *See supra* Part II.A.1.a–b.

[48] 11 U.S.C. §§ 1141 and 101(5).

[49] In re *Mark IV Indus., Inc*., 438 B.R. 460, 467 (Bankr. S.D.N.Y. 2010), *aff'd*, 459 B.R. 173 (S.D.N.Y. 2011). The court actually ruled that there were three factors. *Id.* The first factor was whether only the debtor could comply with the obligation. *Id.* An agency's ability to demand payment to perform the costs would not fall under that court's first factor. The third factor was whether the debtor could demand to simply pay the agency in lieu of performing the obligation. *Id.* at 468. I felt that the separation of the first and third factors was not supported by case law. In reality, the first and third factors fall under the same general test of whether the debtor could pay damages—whether on account of retroactive or prospective cleanup costs.

[50] *Id.* at 467–68.

[51] *Id*. at 468.

[52] In re *Chateaugay Corp*., 944 F.2d 997, 1008 (2d Cir. 1991).

[53] *See*, *e.g*., *id.* (stating that response costs incurred by EPA under CERCLA were prepetition claims); Boston & Me. Corp. v. Mass. Bay Transp. Auth., 587 F.3d 89 (1st Cir. 2009) (holding reimbursement claims incurred by MBTA for cleanup costs were discharged under predecessor's bankruptcy petition twenty years earlier).

order requiring the debtor to clean up a hazardous waste site.[54] The debtor failed to comply, and the state appointed a receiver who took possession of the debtor's property.[55]

The Court reasoned that the dispossession of the debtor's property converted the debtor's cleanup obligations into a right to payment because the debtor was no longer capable to comply with the obligation by means other than payment.[56] As such, the obligation was dischargeable. [57]

A state's order requiring a debtor to expend money on account of an obligation does not necessarily mean that the debtor's compliance can be reduced to payment. The distinction typically falls on whether the state agency receives the costs directly.[58] If the debtor is required to pay the state agency, such as reimbursement costs, then the obligation will be a claim dischargeable in bankruptcy because it can be reduced to payment. In contrast, the obligation will not be a claim if the debtor has to pay third parties to comply with the order. The debtor in such a situation is deemed capable of complying with the obligation.[59] Thus, the state's claim will not be discharged.

b. Ongoing Harms Cannot Be Reduced to Payment

Courts have generally held that ongoing harm cannot be reduced to monetary payment.[60] Because ongoing harm cannot be reduced to monetary payment, it cannot be discharged as a claim in bankruptcy.

This factor is accompanied by a caveat: courts that have relied on the underlying statute. The Seventh Circuit in *In re CMC Heartland Partners*, for instance, was faced with the question of whether a debtor's previous confirmation under the Bankruptcy Act discharged a CERCLA claim for ongoing waste seepage stemming from pre-petition conduct.[61] The court looked to CERCLA Section 106(a) to determine whether the EPA could seek judicial relief to cease the pollution.[62] The court noted that CERCLA Section 106(a)

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[54] *Ohio v. Kovacs*, 469 U.S. 274, 276 (1985).

[55] *Id*.

[56] *Id*. at 282.

[57] *Id.* at 283.

[58] In re *Torwico Elecs., Inc*., 8 F.3d 146, 150 (3d Cir. 1993) (holding that debtor's Chapter 11 plan did not discharge cleanup obligation to the New Jersey Department of Environmental Protection and Energy where debtor was required to expend money in order to comply with the order).

[59] *Id*.

[60] *See*, *e.g.*, *Chateaugay* 944 F.2d at 1008.

[61] In re *CMC Heartland Partners*, 966 F.2d 1143, 1145 (7th Cir. 1992).

[62] *Id*. at 1147.

requires the EPA to show "an imminent and substantial endangerment to the public health or welfare or the environment because of an actual or threatened release of a hazardous substance" before there could be statutory relief.[63] Whether bankruptcy was an obstacle to the EPA's recovery depended on their ability to meet their burden under Section 106(a).[64]

Similarly, the Third Circuit's holding in *Torwico* relied on the underlying environmental statute.[65] The statute did not provide the state with an option to accept payment in lieu of continued pollution.[66] The court reasoned that the obligation could therefore not be reduced to payment.[67]

B. Section 363 Sale

1. "Interest in Such Property" May be Broadly Interpreted to Include Environmental Obligations

A plain reading of Section 363(f) would protect environmental agencies. Section 363(f)'s language does not appear to conflict with nonbankruptcy law because only "interests in such property" may be stripped during a 363 sale.[68] The Bankruptcy Code does not define either "interest in such property," but a "lien" is defined as any "charge against or interest in property."[69] Sales free and clear of "interests in property" would thus appear to be limited to liens. It would follow that a Section 363 sale could not be used to sell an asset free and clear of non-lien obligations. This statutory protection has dissolved because courts have expanded the definition of "interest in such property" broadly.[70] Consequently, a debtor in possession may have an option to sell its assets free and clear of environmental obligations to a purchaser.

a. The Definition of "Interest in Such Property" is Broader than Liens, Security Agreements, and Other Encumbrances

The Third Circuit's opinion in *In re Trans World Airlines, Inc.,*[71] is a

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[63] *Id*. at 1145.

[64] *Id*. at 1148.

[65] *In re* Torwico Elecs., Inc., 8 F.3d 146, 151 (3d Cir. 1993).

[66] *Id.*

[67] *Id*.

[68] *See* 11 U.S.C. § 363(f).

[69] 11 U.S.C. § 101(37).

[70] George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L. J. 235, 236 (2002).

[71] 322 F.3d 283, 286 (3d Cir. 2003).

prominent example of the court's expansive reading of Section 363(f). Trans World Airlines ("TWA") had gone ten years without making a profit.[72] TWA had engaged in conversations with American about the prospect of forming a strategic partnership months before it filed for bankruptcy.[73] After filing for bankruptcy, TWA sold substantially all of its assets to American Airlines ("American") through Section 363.[74] The purchase agreement included a provision that excluded American from liability for a pending employment discrimination charge against TWA by the EEOC.[75] The debate on appeal centered on the meaning of the term "interest in such property."[76] The Appellants' position was that "interest[] in [such] property" is limited to "liens, mortgages, money judgments, writs of garnishment and attachment, and the like. . . ."[77] The Airline contended that "interest in [such] property" "should be broadly read to authorize a bankruptcy court to bar any interest that could potentially travel with the property being sold, even if the asserted interest is unsecured."[78] The Third Circuit adopted the Airline's broad definition of "interest in such property."[79]

The Third Circuit determined that an employment discrimination claim is an interest in property because it arose from the property being sold.[80] The employment discrimination claim arose from the property being sold because, were it not for the sale of the property to American, TWA would not have been able to operate as an airline, and therefore TWA would not have had the employees.[81]

The courts have similarly diluted the protections afforded by Rule 4001. Rule 4001 grants a party a hearing to contest a Section 363 sale.[82] When the Bankruptcy Code was first enacted, courts required a debtor in possession to show that prompt sale was an "urgent necessity" for a sale of substantially all assets outside of the ordinary course of business.[83] The Second Circuit later abandoned a showing of urgent necessity as a requirement so long as there was

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[72] *Id.* at 286.

[73] *Id.*

[74] *Id.*

[75] *Id*. at 285.

[76] *Id.* at 288.

[77] *Id.*

[78] *Id.*

[79] *Id.*

[80] *Id.* at 289.

[81] *Id*. at 290

[82] Fed. R. Bankr. P. 4001.

[83] Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 730 (2009).

an articulated business purpose.[84] The increased discretion assumed by the courts is troublesome when examining the results of proposed section 363 sales. In an extensive study of modern section 363 sales of large public companies, LoPucki and Doherty found no case in which the court did not approve the proposed sale.[85] LoPucki and Doherty attribute the courts' accommodation of the debtors' wishes to court competition.[86] Citing the right of the debtor to choose the forum, as well as the economic incentives of a jurisdiction to hear large bankruptcy cases, LoPucki and Doherty argue that courts have become increasingly more lenient in permitting debtors proposed sales.[87]

In re Trans World Airlines, Inc.,[88] serves as an example of courts' leniency in allowing section 363 sales. The EEOC and a class of flight attendants objected to the sale pursuant to R. 4001.[89] The Bankruptcy Court approved the sale over the objection, and the District Court affirmed.[90] A determinative reason for allowing the sale despite the provision eliminating successor liability was that the evidence offered supported the proposition that "it was unlikely that debtors and American Airlines ("American") would have consummated the sale if appellants' claims were not extinguished."[91] Evidence was also offered demonstrating that without the sale, Trans World Airlines ("TWA") would have been liquidated, which would have resulted in material harm to a variety of constituents, including employees.[92] This was over the objection that this was unlikely given the small amount of the claims relative to the $742 million sale price.[93]

b. A Section 363(f) Sale May Cut Off Successor Liability

A "'de facto' merger occurs where one corporation is absorbed by another, but without compliance with the statutory requirements for a merger."[94] The sale of substantially all of a company's assets to another company through

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[84] *Id.*

[85] Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 40 (2007).

[86] *Id.*

[87] *Id.*

[88] 322 F.3d 283 (3d Cir. 2003).

[89] *Id.* at 286.

[90] *Id.*

[91] *Id.* at 287.

[92] *Id.*

[93] Brief for the Fed. Appellants at 15, In re *Trans World Airlines, Inc*., Nos. 01-1788, 01-4159, 01-4437 (3d Cir. Jan. 1, 2001)

[94] *Cargo Partner AG v. Albatrans Inc.*, 207 F. Supp. 2d 86, 96 (S.D.N.Y. 2002), *aff'd*, 352 F.3d 41 (2d Cir. 2003).

Section 363 falls under this definition. Therefore, whereas a third party would be able to avoid obligations through a sale free and clear, the successor in a de facto merger would remain liable.

Section 363 has been interpreted to allow a debtor to avoid the doctrine of successor liability in some circumstances. This interpretation has notably been applied regarding obligations owed retirees in section 1114. Unlike most unsecured claimants, the Bankruptcy Code's plain language requires the debtor in possession to engage in consensual negotiations before retiree benefits can be altered or terminated, even in the absence of a plan.[95] A debtor in possession seeking to sell substantially all of its assets as a going concern is therefore bound by Section 1114.

A debtor in possession seeking to modify or terminate retiree benefits is required to fulfill several conditions before modification may be sought.[96] These conditions must be fulfilled "[s]ubsequent to filing a petition and prior to filing an application seeking modification of the retiree benefits. . . ."[97] The statute is otherwise silent in regard to the timing requirements.

The statute's silence regarding the timing requirements imposed on the debtor in possession was a determinative factor in allowing New General Motors to purchase Old General Motors as a going concern through a section 363 sale.[98] The court held that in the absence of express language to the contrary, Section 1114's obligations would not need to be fulfilled prior to a section 363 sale.[99] In interpreting the statute in this manner, the court approved the sale before Section 1114 was complied with.

The court's timing interpretation would be of little consequence to the objecting retirees if the retirees were then allowed to pursue their claims against the successor, New General Motors. New General Motors, however, likely did not desire this burden and so sought to purchase the property free and clear of all interests in property pursuant to section 363(f). The court, consistent with *In re Trans World Airlines, Inc.*, followed the broad-reaching interpretation of "interest in such property," and held that section 363(f) could cut off section 1114 claims of retirees to the successor.[100] Furthermore, it noted that the statute only requires the debtor in possession to comply with Section 1114, and not any successor.[101]

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[95] 11 U.S.C. § 1114(e)(1) (2012).

[96] § 1114(f)(1).

[97] *Id.*

[98] In re *Gen. Motors Corp*., 407 B.R. 463, 511 (Bankr. S.D.N.Y. 2009), *aff'd sub nom.* In re *Motors Liquidation Co.*, 430 B.R. 65 (S.D.N.Y. 2010)

[99] *Id.*

[100] *Id.* at 505.

[101] *Id.* at 509.

What was left was a requirement by an asset-less debtor in possession who would no longer be pursuing business to comply with Section 1114. The court noted the obvious inequity that would result: like any other unsecured claimant, the retirees would be general unsecured creditors who would only receive a fraction of their claim.[102]

c. Practical Impact of Expansive Reading

Lopucki and Doherty do not deny that debtors often give valid reasons to the court in order to have the sale approved.[103] However, LoPucki and Doherty note that, in their research, they found that claims made by the debtor are generally false.[104] It is speculative to assert that any future company could successfully reorganize in Chapter 11, but *In re Trans World Airlines, Inc.*, *In re General Motors, Corp*, and other successful section 363 sales signal to future companies that courts may allow them to avoid obligations through a section 363 sale simply if they offer some evidence supporting their position.

III. THE IMPACT OF BANKRUPTCY ON CALIFORNIA'S CAP-AND-TRADE PROGRAM

A. Overview of AB 32

The California Air Resources Board ("CARB") approved Assembly Bill 32, California's Global Warming Solutions Act,[105] ("AB 32") in October 2011.[106] AB 32 requires California to reduce its greenhouse gas ("GHG") emissions to 1990 levels by 2020.[107] AB 32 seeks to meet this goal in GHG reductions largely through a statewide comprehensive cap-and-trade program.[108]

A cap-and-trade program is an efficiency-seeking market-based mechanism where a finite good is, through secondary market sales, allotted to each party depending on their need and marginal costs. GHG emissions are the

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[102] *Id.* at 510.

[103] LoPucki & Doherty, *supra* note 96

[104] *Id.* at 39.

[105] CAL. ENVT. L. PROTECTION AGENCY: AIR RESOURCES BD.: Assembly Bill 32: Global Warming Solutions Act (codified at CAL HEALTH AND SAFETY CODE § 38500 (2014)). Note that while the legislature passed and Governor Schwarzenegger signed AB 32 in 2006, CARB did not approve AB 32 until October 20, 2011.

[106] Peter Hsiao et al, *California Adopts Historic Cap-and-Trade Program for Greenhouse Gas Emissions*, ST035 ALI-ABA 147, 149

[107] CAL. ENVT. L. PROTECTION AGENCY: AIR RESOURCES BD.: Proposed Regulation to Implement the California Cap-and-Trade Program, Part I, Volume I, at II-1.

[108] *Id.* AB 32's cap-and-trade program will cover about eighty-five percent of the State's GHG emissions. *Id.*

finite resource created by AB 32. The total available supply, or "cap," of GHG emissions is set at 165.8 million $MTCO_2E$,[109] which represents the emissions expected from covered sources for 2012.[110] Covered entities will initially receive from the state an initial allotment of allowances representing their market share of the total cap. Each allowance is equal to one $MTCO_2E$, and these allowances may be transferred from one covered entity to another in the secondary market based on need—hence the "trade."[111] The cap will decline each year gradually until it equals 1990 levels by 2020.[112]

Covered entities are required to surrender thirty percent of allowances equal to their verified emissions for each of the first two years of the three-year compliance period.[113] Covered entities must turn in their remaining allowances at the end of the three-year compliance period.[114] Failure to turn in the correct number of allowances in a timely manner, or turning in emissions that exceed the number of valid compliance instruments by the deadline will be penalized in two ways.[115] First, an entity that fails to accurately meet either the annual or triennial deadline is required to submit allowances equal to four times the entity's excess emissions.[116] Second, CARB may apply a $25,000 fine per missing allowance every forty-five days starting thirty days after the failure to submit the allowances for excess emissions until the violation is rectified.[117]

B. Excess Emissions Penalty Likely Cannot be Avoided Through a Chapter 11 Plan

1. Overview

California's carbon emissions cap-and-trade program limits covered entities' levels of production. A covered entity may only produce up to the number of allowances it is allotted. If a covered entity wishes to produce in excess of its allotment, it must purchase additional allowances from other

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[109] $MTCO_2E$ stands for metric tons of carbon dioxide equivalent. The standard measurement is based on the relative heat-trapping potential of carbon dioxide. *Id.* at II-2.

[110] *Id.* at II-3.

[111] *Id.*

[112] *Id.*

[113] *Id.*

[114] *Id.* at II-6.

[115] *Id.* at II-7. Note also that a covered entity is able to offset eight percent of their allowances. Hsiao, *supra* note 119, at 2.

[116] Alex Hoover, *Understanding California's Cap-and-Trade Regulations*, ASS'N OF CORP. COUNS. (last updated May 11, 2013), http://www.acc.com/legalresources/quickcounsel/UCCTR.cfm.

[117] *Id.*

allowance-holders. Purchases will be limited to the point where the cost of an additional allowance is equal to its marginal benefit. While this would ideally produce a socially efficient level of production, it will likely produce a lower level of production compared to the entity's desired level of production. Failure to comply with the program would result in high costs to the producer. First, they would be penalized four allowances for every one of which they are in excess. Failure to rectify the issue will lead to an additional $25,000 dollars every forty-five days.

A covered entity would like to be able to produce at its private equilibrium without facing CARB's penalties. Consider a covered entity nearing the end of its triennial. Assume that, while it complied with each annual compliance period, it has emitted in excess of its total allowances. Facing the penalty of losing four allowances per one metric ton it exceeded, the entity knows that it will be at a competitive disadvantage for the following years. The entity will ask itself whether it can avoid the upcoming penalty by filing a Chapter 11 petition and confirming a plan. The entity will hope that the upcoming allowance penalty will be deemed a claim dischargeable in bankruptcy. Once discharged, the entity will no longer be required to comply. It will have been able to produce in excess of its allowances with no penalty. California's goal of reducing greenhouse gas emissions will be undermined.

As discussed *supra*, the obligation may be avoided if it is a claim.[118] It is a claim if it is pre-confirmation and can be reduced to payment.[119] While the obligation will likely be deemed pre-confirmation, it probably could not be reduced to payment. A Chapter 11 plan will therefore not offer the entity the benefits it desires.

2. Are Allowance Deductions Pre-Confirmation Obligations?

Bankruptcy courts, while not bound by a Bankruptcy Appellate Panel or District Courts outside of their district, are bound by circuit decisions.[120] Assuming that most bankruptcy petitions will be filed in California, most AB 32 bankruptcy cases will follow the Ninth Circuit's test.

It is important to look at other tests to account for forum shopping. It is possible that a debtor will choose to file in a bankruptcy court other than California if it believes it can gain a strategic advantage. For this reason, I will discuss the likely success chances of a Chapter 11 debtor seeking to avoid allowance deduction penalties under each of the three major tests.

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[118] *See supra* Part II.A.2.

[119] 11 U.S.C. § 101(5).

[120] In re *Silverman*, 616 F.3d 1001, 1005 (9th Cir. 2010).

Courts in the Second and Ninth Circuits will likely find that the forfeiture of future allowances due to excess admissions occurred pre-confirmation. Courts following the District of Minnesota's test will likely find that the penalties did not occur pre-confirmation.

a. Penalties Are Pre-confirmation Liabilities Under the Second Circuit Test

An entity's forfeiture of allowances will likely be deemed pre-petition under the Second Circuit's Relationship Test. The relationship test looks to see if the pre-existing relationship between the environmental agency and the debtor provides a "sufficient contemplation" of the contingency.[121] Just as the court in *Chateaugay* held that the EPA could have sufficiently contemplated that the debtor's production could lead to CERCLA liability which the EPA may incur costs to clean up,[122] a court will likely find that CARB sufficiently contemplated that a greenhouse gas emitting entity could produce in excess of their allowances.

b. Penalties Are Pre-confirmation Liabilities Under the Ninth Circuit Test

The incurrence of allowance deduction penalties would also be deemed pre-confirmation under the Ninth Circuit's Conduct Test. The Conduct Test looks to the debtor's first act that led to the ultimate liability as the moment the claim arose.[123] An emissions-producing entity's first act would be the moment it first started production. Production occurred pre-confirmation.

c. Penalties Are Not Pre-confirmation Liabilities Under the District of Minnesota Test

A court following the District of Minnesota's test will likely find that allowance deduction penalties did not arise pre-confirmation. The District Court of Minnesota looks towards the statute under which the liability arose to determine whether obligation was incurred pre- or post-confirmation.[124] AB 32's allowance deduction could arise at a couple of different points.

The first point is the moment in which the entity produced in excess of its allowances. That occurrence will trigger the CARB's penalties. If this is the

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[121] In re *Chateaugay Corp*., 944 F.2d at 1005

[122] *See id*.

[123] In re *Jensen*, 995 F.2d 925, 931 (9th Cir. 1993).

[124] *Union Scrap Iron & Metal*, 123 B.R. at 836-37.

accepted moment and the entity files for Chapter 11 after this date, then the claim arose pre-confirmation.

The court could alternatively find the moment the penalties are assessed—that is, at the end of the triennial period—to be the date that the obligation arose. If this is the accepted moment and the entity files for Chapter 11 prior to this date (as the entity did in our hypothetical), then the claim did not arise pre-confirmation.

The court will likely find that the latter date—the end of the triennial—as the date the obligation arose. The court in *Union Scrap Iron & Metal* deemed the incurrence to occur immediately after the last of all the statute's elements were met.[125] This included not only all acts of the debtor, but all necessary acts of the environmental agency as well. Following this method, while the debtor's acts are completed once it exceeds its allowances (likely pre-confirmation), liability does not arise until CARB imposes the penalty (likely post-confirmation). A court following the District of Minnesota will thus likely deem allowance deduction penalties to be a post-confirmation obligation unable to be discharged in bankruptcy.

3. Environmental Liabilities Do Not Produce a Right to Payment?

A pre-confirmation liability can be a dischargeable claim only if it can be reduced to payment.[126] An environmental liability can be reduced to payment only if (1) the environmental agency can be made whole with monetary damages; and (2) the debtor's actions do not create ongoing harm.[127] While debatable, a court will likely find that neither of these elements will be met.

a. CARB Cannot Be Made Whole Through Damages

An obligation cannot be reduced to payment unless the environmental agency can receive damages to ameliorate the harm.[128] AB 32 does not allow CARB to receive payment directly from a violator seeking to avoid allowance deduction penalties. An entity with excess production may purchase additional allowances to match their production. If they fail to do so—for instance, if all allotted allowances have been used such that there's none left to purchase—CARB cannot accept payment in exchange for a reduction in allowance penalties for the coming year. Since CARB cannot receive damages, the

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[125] United States v. Union Scrap Iron & Metal, 123 B.R. 831, 835 (D. Minn 1990).

[126] 11 U.S.C. § 101(5).

[127] *In re* Mark IV Indus., Inc., 438 B.R. 460, 467–68 (Bankr. S.D.N.Y. 2010), *aff'd*, 459 B.R. 173 (S.D.N.Y. 2011).

[128] *In re* Chateauguay Corp., 944 F.2d at 1008.

obligation cannot be reduced to payment.

b. Climate Change Poses Ongoing Harm

Courts will also likely find that there is an ongoing harm. A liability cannot be reduced to payment if there is ongoing harm.[129] Courts will look towards the underlying statute to determine whether harm is ongoing. AB 32 notes that climate change poses a "serious threat to the economic well-being, public health, natural resources, and the environment of California."[130] AB 32 seeks to curb this harm by reducing greenhouse gas levels to 1990 levels by 2020.[131] Any emissions in excess of the 1990 levels would thus cause continuing harm under the statute. The allowance deduction penalty is imposed in order to align within this reduction goal. As it is a prospective goal, and not just a matter of rectifying a past issue, courts will likely find that it is ongoing.

The hypothetical Chapter 11 debtor described above will therefore not be able avoid imminent allowance deduction penalties through a Chapter 11 plan. Only a claim may be discharged through a Chapter 11 plan.[132] Allowance deduction penalties will likely not be viewed as a claim because they cannot be reduced to payment.[133] It is possible, however, for our Chapter 11 debtor to avoid allowance deductions in bankruptcy through means other than a plan.

C. Allowance Deduction Penalty May be Avoided Through a Section 363 Sale

1. Allowance Deductions as an Interest in Property

Section 363 allows a debtor to sell property free and clear of "any interest in such property."[134] A debtor may be able to sell an allowance deduction if it is considered an interest in the property. The outcome therefore turns on the definition of "interest in such property."

Allowance deductions are not an interest in property under the traditional definition. An allowance deduction is not a lien, even if it arises under state law, because CARB would not be able to recover costs from the property. The allowance deduction is not a security agreement both because CARB has no

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[129] *In re* Mark IV Indus., Inc., 438 B.R. 460, 468 (S.D.N.Y. 2010).

[130] CAL. HEALTH & SAFETY CODE § 38501 (2014).

[131] CAL. ENVT. L. PROTECTION AGENCY: AIR RESOURCES BD.: Proposed Regulation to Implement the California Cap-and-Trade Program, Part I, Volume I, at II-3.

[132] *See* 11 U.S.C. § 1141(d)(1)(A) (2012).

[133] *See* § 101(5).

[134] § 363(f).

charge against the property to secure its liability and because the liability is nonconsensual. Failing to be a lien or security agreement, allowance deductions cannot be sold free and clear under the traditional definition because they are not interests in property.

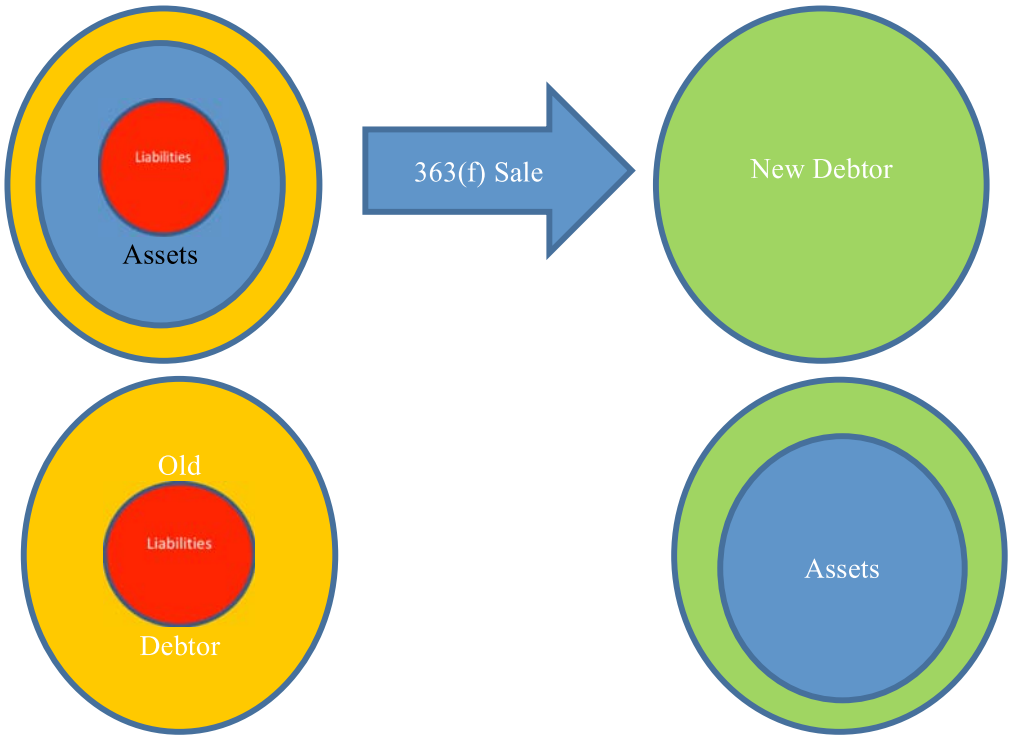
An allowance deduction will likely be considered an interest in property under the Third Circuit's test. The Third Circuit deems any liability that arose from the property being sold as an interest in property.[135] Allowance deduction penalties arose from the property; the property produced the emissions, the emissions were in excess, and due to excess emissions, allowances were deducted. As an interest in such property, the property can be sold free of the liability.

2. Retaining the Company's Assets But Not Its Environmental Liabilities

An entity seeking a competitive advantage by avoiding allowance deductions through a Section 363 sale would not benefit if it sold its assets to a third party. The entity would in such an instance simply cease to exist. It would be preferable in that instance to incur allowance penalties and continue, albeit at lesser capacity. An entity must therefore find a way to sell its assets, free of the liability, to itself.

The entity can solve this problem, using General Motors as inspiration, by creating a new company. Consider our hypothetical Chapter 11 debtor above. We will name him "Old Debtor." Old Debtor's estate consists of all its assets, which include all machinery necessary for production, as well as all its liabilities, which include the upcoming allowance deduction penalty. Old Debtor's management will then create a new company, who we will call "New Debtor." Old Debtor will agree to sell all its assets to New Debtor through a Section 363 sale. New Debtor will agree to purchase the assets only if it can be assured that the allowance deduction penalties will not be attached to the property. If the court interprets "interest in such property" broadly to include allowance deduction penalties then the assets can be transferred free and clear.

The effect of the transaction is demonstrated below. Old Debtor's estate consists only of liabilities, including allowance deduction penalties. New Debtor consists only of Old Debtor's assets, free of allowance deduction penalties.



The transaction is in effect a merger. The successor in a merger is responsible for the liabilities of the predecessor under state law. The courts in *In re General Motors, Corp*, however, interpreted "interest in such property" to include successor liability claims.[136] A court following this interpretation would thus prevent CARB from enforcing its obligations on New Debtor. CARB would be limited to enforce against Old Debtor. While Old Debtor exists, the allowance penalties would have no impact because Old Debtor's production has been moved to New Debtor. Our hypothetical Chapter 11 debtor has thus successfully produced in excess of social equilibrium to its competitive advantage without incurring any penalties. AB 32 is undermined.

IV. A JUDICIAL SOLUTION

A. Courts Should Interpret "Interest in Such Property" to Exclude Allowance Deductions

A court's decision to interpret "interest in such property" broadly enough

[136] *In re* Trans World Airlines, Inc., 322 F.3d 283, 289 (3d Cir. 2003). [136] *In re* Gen. Motors Corp., 407 B.R. 463, 511 (S.D.N.Y. 2009).

to allow a debtor to avoid allowance deductions and successor liability cannot be solved unless either Section 363 is rewritten to define "interest in such property" more narrowly. It is unlikely that the Bankruptcy Code will be rewritten simply to close this loophole, especially since the new language may have unwanted ramifications. I would simply like to call on judges to restrain from following the reasoning of *In re Trans World Airlines, Inc.,* and *In re General Motors, Corp*. Courts bound by those decisions can avoid their reasoning by distinguishing the cases.

In re Trans World Airlines, Inc., involved the treatment of a "claim" under Section 363.[137] As explained *supra*, allowance deductions are not a claim.[138] So while the court in *In re Trans World Airlines, Inc.,* held that claims, even unsecured ones, could be sold free and clear, it does not necessarily follow that environmental obligations can similarly be sold free and clear.

In re General Motors, Corp, determined that bankruptcy-imposed obligations did not block a Section 363 sale if those obligations could be fulfilled after the sale.[139] Allowance deductions are neither bankruptcy-specific nor could they be fulfilled after a sale of all the debtor's assets free and clear of them. It does not necessarily follow from the court's reasoning that allowance deductions can be sold free and clear.

California has a legitimate interest in reducing greenhouse gas emissions. Courts should not loosely interpret text in a manner that allows producers to undermine this interest. Courts should not interpret allowance deductions as an "interest in such property."[140]

B. Attaching a Security Interest to Allowance Deductions Will Not Prevent Sales Free and Clear

Justice O'Connor observed in *Kovacs* that bankruptcy may circumvent a state's legitimate interest in preserving the environment.[141] O'Connor suggested that states could avoid this result by amending their statutes to attach liens to secure environmental obligations.[142]

Assuming that a court finds allowance deductions to be a "claim," O'Connor's proposal would help ensure that Chapter 11 debtors could not avoid allowance deductions through a plan. This would work best if California imposed a statutory lien senior to all other liens and security interests. Unlike an

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[137] *In re* Trans World Airlines, Inc., 322 F.3d at 288.

[138] *See supra* Part III.B.3.b; § 101(5).

[139] *In re* Gen. Motors Corp., 407 B.R. at 511.

[140] *See* 11 U.S.C. § 363(f) (2012).

[141] *Ohio v. Kovacs*, 469 U.S. 274, 285 (1985) (O'Connor, J., concurring).

[142] *Id.* at 286.

unsecured claim, a lienholder of a Chapter 11 debtor would be ensured the full amount of their claim up to the value of the property.[143] The lienholder would have an unsecured claim for any deficiency.[144] Granting CARB a lien would thus ensure the agency at least greater recovery costs than they would receive without a lien. It is still possible that the amount of the liability would exceed the value of the property, particularly since properties encumbered by environmental liabilities would likely see their values deflated.

It should also be noted that O'Connor's proposal would dramatically alter the rights of other secured parties, such as mortgagees and innocent judgment creditors. The chart below provides an example of an environmental lien's effect. Assume that the debtor holds no other assets than the property, that the property is fully encumbered by a mortgage, that the property is worth $600,000, and that the allowance deduction liability is an estimated claim set at $700,000.[145]

CARB would receive nothing in bankruptcy without a lien. Following the attachment of the lien, however, CARB is to receive at least $600,000 from the value of the property. To what extent the $100,000 deficiency is paid and to what extent the secured party is paid will depend on the perceived success of the debtor moving forward.[146]

Justice O'Connor's solution does not, however, protect CARB when facing a Section 363 sale free and clear of allowance deductions. By any definition of "interest in property," the lien can be sold free and clear. While Justic O'Connor's proposal is effective against a Chapter 11 plan, debtors may still be able to avoid allowance deductions.

V. CONCLUSION

Broad judicial interpretation of Section 363 could allow bankruptcy to be a forum in which covered entities may avoid AB 32's cap-and-trade regulations. Courts best have the power to prevent this outcome because the legislature's remedies of liens and other penalties will not be effective. Proper statutory reading and distinguishing precedent allows courts to help effectively implement AB 32.

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[143] 11 U.S.C. § 506(a).

[144] *Id.*

[145] The allowance deduction claim would likely be considered a contingent or unliquidated claim subject to estimation. *See* 11 U.S.C. § 502(c).

[146] § 1129.